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## Construction Lending Program

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### Examination Objectives

To determine if policies, practices, procedures, and internal controls regarding real estate construction loans are adequate.

To verify that management is operating in conformance with the established guidelines.

To evaluate the construction loan portfolio for credit quality, collectibility, and collateral sufficiency.

To assess the scope and adequacy of the audit function.

To ensure compliance with applicable laws and regulations.

To identify the strengths and weaknesses of the construction lending function.

To initiate corrective action when policies, practices, procedures, objectives, or internal controls are deficient or when violations of laws or regulations have been noted.

### Examination Procedures

#### Level I

**Wkp. Ref.**

1. Review the construction lending policy and procedures for adequacy given the volume and type of lending activity. Determine if the policy conforms to 12 CFR §563.100-101, Real Estate Lending Standards. Specifically, focus on whether the policy and procedures address and are adequate with regard to:
  - a. Geographic limits.
  - b. Lending authority for committee and individual officers.
  - c. Procedures for reviewing construction loan applications.
  - d. Borrower financial strength requirements.
  - e. Acceptable loan types and features.

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- f. Agreements required by borrowers for completion of improvements in accordance with approved construction specifications and cost and time limitations.
- g. Qualified collateral and minimum margin requirements.
- h. Acceptable appraisal techniques.
- i. Acceptable feasibility report standards.
- j. Inspection procedures.
- k. Methods of supervising loan proceed disbursements.
- l. Standards for take-out commitments.
- m. Completion bonding requirements.
- n. Minimum standards for documentation.
- o. Internal controls regarding construction loan documents and separation of duties in the areas of the preparation, posting, and reconciliation of loan records, and in the areas of loan approvals, appraisals, disbursements, and inspections.
- p. Collection and charge-off procedures.
- q. Review and approval by the board of directors at least annually.
- r. Compatibility with the business plan and current market conditions.
- s. Aggregate limitation for construction loans.

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2. In conjunction with the regulator(s) performing the audit programs (Thrift Activities Handbook Sections 350, External Audit, and 355, Internal Audit), review the scope and depth of the work performed by internal and external auditors in the construction lending area. Obtain a list of any deficiencies or exceptions contained in the latest review and determine if the association made the appropriate corrections.
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3. In conjunction with the examiner performing Thrift Activities Handbook Section 210, Lending Risk Assessment, obtain and review the following information and schedules as they pertain to construction lending:
- a. Lending policy and procedures.
  - b. Appraisal and feasibility report standards for construction projects.
  - c. Construction loan trial balance, undisbursed loan proceeds (LIP) trial balance, and listing of contingency and escrow accounts.
  - d. Past due loans.
  - e. Loans in a nonaccrual status.
  - f. Loans in which interest is not being collected in accordance with the terms of the loan.
  - g. Loans whose terms have been modified by a reduction of interest rate or principal payment, by a deferral of interest or principal, or by other restructuring of repayment terms.
  - h. Loan participations purchased and sold.
  - i. Loans sold in full since the previous examination.
  - j. Loans considered "problem loans" by management.
  - k. Loans that are overdisbursed.
  - l. Loan commitments and contingent liabilities.
  - m. Extensions of credit to employees, officers, directors, principal shareholders, and their interests.
  - n. Extensions of credit to officers, directors, and principal shareholders of other institutions.
  - o. Current interest-rate structure/loan pricing.

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- p. Level of each officer's current lending authority.
- q. Pertinent reports furnished to the board of directors and loan committee, including reports required by the board pursuant to its written real estate lending policies and 12 CFR 563.100-101.

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- 4. Review the preceding report of examination and all construction lending-related exceptions noted and determine if the association made the appropriate corrections.
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- 5. Summarize findings, obtain management responses, and update programs and the continuing examination file (CEF) with information that will facilitate future examinations. File exception sheets in the general file.
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- 6. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.
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### Level II

- 7. Reconcile the construction loan trial balance and undisbursed loan proceeds and contingency or escrow accounts to the general ledger and review reconciling items for reasonableness.
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- 8. Using an appropriate sampling technique, select loans for review and transcribe appropriate information to the Construction Loan Review and other Thrift Activities line sheets, where appropriate, including indication of any past-due, nonaccrual, or problem status. (For details on sampling, refer to Section 209 of the Thrift Activities Regulatory Handbook.)
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9. Prepare Construction Loan Review line sheets for any loans not in the sample that require in-depth review based on information contained in the above schedules. In performing this step, also consider including the following:
- a. Loans granted and participations purchased since the previous examination.
  - b. Loans sold in full since the preceding examination.
  - c. Multiple loans to the same borrower or related group of borrowers, particularly those that represent a concentration of credit.
  - d. Loan commitments and other contingent liabilities.
  - e. Loans to affiliated persons.
  - f. Tract loans.
  - g. Out-of-territory loans.
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10. Obtain the association's credit or loan files on the loans to be reviewed. In conjunction with analyzing the loans, test for compliance with the association's established policies, procedures, and controls. In analyzing the loans determine and consider the following:
- a. Analyze the loan for credit quality by determining the adequacy of primary and secondary sources of repayment, including the value, quality, and liquidity of the security property and any other collateral support. Financial statements from previous and current periods, as well as loan officer memoranda and correspondence, should be analyzed to determine the existence of any unfavorable or adverse trends.
  - b. Whether the amount of construction loans and their estimated completion dates correspond to the amounts and expiration dates of the take-out commitments or completion bonds.
  - c. The financial strength and reliability of take-out or permanent lenders.

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- d. Whether bonding companies and the permanent lenders have approved of any modifications to the original agreements.
- e. Whether properties securing construction loans without prearranged permanent financing will be readily saleable when completed.
- f. Whether inspection reports are maintained and reviewed by persons independent of the inspector and whether they support disbursements to date.
- g. Whether the amount of undisbursed loan funds is sufficient to complete the project.
- h. Whether title records reflect the primacy of the institution's lien position.
- i. Whether adequate builder's risk insurance is maintained.
- j. The adequacy of any secondary support afforded by guarantors and endorsers.
- k. Compliance with established policy and procedures.
- l. Compliance with applicable laws and regulations.
- m. Loans not supported by current and complete financial information.
- n. Loans in which collateral documentation is deficient.
- o. Compliance with provisions of any loan agreements.
- p. Whether the original amount of the loan was within the lending officer's authority.
- q. Whether the interest rate charged and terms are within the established parameters of the interest-rate schedule and whether loans to affiliated persons of this or other institutions represent preferential treatment and actual or potential conflicts of interest.

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11. For participation loans purchased and sold and loans sold in full since the preceding examination:

- a. Test participation certificates and records and determine that the parties share in the risks and contractual payments on a pro rata basis.

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- b. Determine that the books and records properly reflect the institution's liability.
- c. Determine that the institution exercises controls and procedures over loans sold and loans serviced for others similar to those it exercises for loans in its own portfolio.
- d. Investigate any loans or participations sold immediately prior to the examination to determine whether any were sold to avoid criticism during the examination.

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12. For FHA-insured loans and VA-guaranteed loans:

- a. Determine that a valid certificate of insurance or guaranty is on file by reviewing management's procedures to obtain such insurance or guaranty or by test checking a representative sample of such loans.
- b. Determine that required delinquency reports are being submitted.

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13. Determine if construction loan agreements for acquisition and development loans require prudent release payments.

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14. Ensure that the Objectives of this Handbook Section have been met. State your findings and conclusions, as well as appropriate recommendations for any necessary corrective measures, on the appropriate work papers and report pages.

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### Examiner's Summary, Recommendations, and Comments

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